

§ 1.617-3 Recapture of exploration expenditures.

(a) *In general.* (1)(i) Except as provided in subparagraphs (2) and (3) of this paragraph, if in any taxable year any mine (as defined in paragraph (c) of this section) with respect to which deductions have been allowed under section 617(a) reaches the producing stage (as defined in paragraph (c) of this section) the deduction for depletion under section 611 (whether determined under § 1.611-2 or under section 613) with respect to the property shall be disallowed for the taxable year and each subsequent taxable year until the aggregate amount of depletion which would be allowable but for section 617(b)(1)(B) and this subparagraph equals the amount of the adjusted exploration expenditures (determined under section 617(f)(1) and paragraph (d) of this section) attributable to the mine. The preceding sentence shall apply notwithstanding the fact that such mine is not in the producing stage at the close of such taxable year. In the case of a taxpayer who owns more than one property in a mine with respect to which he has been allowed deductions under section 617(a), the depletion deduction described in the second preceding sentence shall be disallowed with respect to all of the properties until the aggregate amount of depletion disallowed under section 617(b)(1)(B) is equal to the adjusted exploration expenditures with respect to the mine. In the case of a taxpayer who elects under section 614(c)(1) to aggregate a mine, with respect to which he has been allowed deductions under section 617(a), with another mine, no deduction for depletion will be allowable under section 611 with respect to the aggregated property until the amount of depletion disallowed under section 617(b)(1)(B) equals the adjusted exploration expenditures attributable to all of the producing mines included in the aggregated property.

(ii) If a taxpayer who has made an election under section 617(a) receives or accrues a bonus or royalty with respect to a mining property with respect to which deductions have been allowed under section 617(a), the deduction for depletion under section 611 with respect to such bonus or royalty (wheth-

er determined under § 1.611-2 or under section 613) shall be disallowed for the taxable year of receipt or accrual and each subsequent taxable year until the aggregate amount of the depletion disallowed under section 617(c) and this section equals the amount of the adjusted exploration expenditures with respect to the property to which the bonus or royalty relates. The preceding sentence shall not apply if the bonus or royalty is paid with respect to a mineral for which a deduction is not allowable under section 617(a). In the case of the disposal of coal or domestic iron ore with a retained economic interest, see paragraph (a)(2) of § 1.617-4.

(2) If the taxpayer so elects with respect to all mines as to which deductions have been allowed under section 617(a) and which reach the producing stage during the taxable year, he shall include in gross income (but not *gross income from the property* for purposes of section 613) for such taxable year an amount equal to the adjusted exploration expenditures (determined under section 617(f)(1) and paragraph (d) of this section) with respect to all of such mines. The amount so included in income shall be treated for purposes of subtitle A of the Internal Revenue Code as expenditures which are paid or incurred on the respective dates on which the mines reach the producing stage and which are properly chargeable to capital account. The fact that a taxpayer does not make the election described in this subparagraph for a taxable year during which mines with respect to which deductions have been allowed under section 617(a) reach the producing stage shall not preclude the taxpayer from making the election with respect to other mines which reach the producing stage during subsequent taxable years. However, the election described in this subparagraph may not be made for any taxable year with respect to any mines which reached the producing stage during a preceding taxable year.

(3) The provisions of section 617(b)(1) and subparagraphs (1) and (2) of this paragraph do not apply in the case of any deposit of oil or gas. For example, A in exploring for sulphur incurred \$500,000 of exploration expenditures which he deducted under section 617(a).

In the following year, A did not find sulphur but on the same mineral property located commercially marketable quantities of oil and gas. In computing the depletion allowance with respect to the oil and gas, no depletion would be disallowed because of section 617(b)(1).

(4) In the case of exploration expenditures which are paid or incurred with respect to a mining property which contains more than one mine, the provisions of subparagraphs (1) and (2) of this paragraph shall apply only to the amount of the adjusted exploration expenditures properly chargeable to the mine or mines which reach the producing stage during the taxable year. For example, A owns a mining property which contains mines X, Y, and Z. For 1970, A deducted under section 617(a), \$250,000 with respect to X, \$100,000 with respect to Y and \$70,000 with respect to Z. In 1971, mine X reaches the producing stage. At that time, A will only have to recapture the \$250,000 attributable to mine X.

(b) *Manner and time for making election.* (1) A taxpayer will be deemed not to have elected pursuant to section 617(b)(1)(A) and paragraph (a)(2) of this section unless he clearly indicates such election on his income tax return for the taxable year in which the mine with respect to which deductions were allowed under section 617(a) reaches the producing stage.

(2) The election described in paragraph (a)(2) of this section may be made (or changed) not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year in which the mine with respect to which deductions were allowed under section 617(a) reaches the producing stage.

(c) *Definitions*—(1) *Mine.* The term *mine* includes all quarries, pits, shafts, and wells, and any other excavations or workings for the purpose of extracting any known deposit of ore or other mineral.

(2) *Producing stage.* A mine will be considered to have reached the producing stage when (i) the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or (ii) the principal activity of the mine is the production of developed ores or

minerals rather than the development of additional ores or minerals for mining.

(3) *Mining property.* The term *mining property* means any property (as the term is defined in section 614(a) after the application of subsections (c) and (e) thereof) with respect to which any expenditures allowed as deductions under section 617(a) are properly chargeable.

(d) *Adjusted exploration expenditures*—(1) *In general.* The term *adjusted exploration expenditures* means, with respect to any property or mine:

(i) The aggregate amount of the expenditures allowed as deductions under section 617(a) for the taxable year and all preceding taxable years to the taxpayer or any other person which are properly chargeable to such property or mine and which (but for the election under section 617(a)) would be reflected in the adjusted basis of such property or mine, reduced by

(ii) The excess, if any, of the amount which would have been allowable for all taxable years under section 613 but for the deduction of such expenditures over the amount allowable for depletion under section 611 (determined without regard to section 617(b)(1)(B)). The amount determined under the preceding sentence shall be reduced by the aggregate of the amounts included in gross income for the taxable year and all preceding taxable years under section 617(b) or (c) and the amount treated under section 617(d) as gain from the sale or exchange of the property which is neither a capital asset nor property described in section 1231.

(iii) If a taxpayer pays or incurs exploration expenditures on a property which contains a producing mine and if such taxpayer deducts any portion of such expenditures under section 617(a), an amount equal to the amount so deducted shall be taken into account in computing the taxpayer's *taxable income from the property* for the purposes of the limitation on the percentage depletion deduction under section 613(a) and the regulations thereunder. The amount of the adjusted exploration expenditures with respect to the producing mine shall be reduced by an amount equal to the amount by which the taxpayer's deduction under 617(a)

(described in the preceding sentence) reduces the taxpayer's deduction for depletion for the taxable year. See example 1 in subparagraph (6) of this paragraph.

(iv) For purposes of § 1.617-4, the aggregate amount of adjusted exploration expenditures with respect to a mining property includes the aggregate amount of adjusted exploration expenditures properly allocable to all mines on such property.

(v) (a) For purposes of paragraph (a)(1) of this section, the aggregate amount of the adjusted exploration expenditures is determined as of the close of the taxpayer's taxable year.

(b) For purposes of § 1.617-4, the aggregate amount of the adjusted exploration expenditures is determined as of the date of the disposition of the mining property or portion thereof.

(2) *Adjustments for certain expenditures of other taxpayers or in respect of other property.* (i) For purposes of subparagraph (1) of this paragraph, the exploration expenditures which must be taken into account in determining the adjusted exploration expenditures with respect to any property or mine are not limited to those expenditures with respect to the property disposed of or which entered the production stage nor are such expenditures limited to those deducted by the taxpayer. For the manner of determining the amount of adjusted exploration expenditures immediately after certain dispositions, see subparagraph (4) of this paragraph.

(ii) If a transferee who at the time of the transfer has not made an election under section 617(a) (including a transferee who has made an election under section 615(e)) receives mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to its basis in the hands of the transferor and with respect to such property the transferor has deducted exploration expenditures under section 617(a), the adjusted exploration expenditures immediately after such transfer shall be treated as exploration expenditures allowed as deductions under section 617(a) to the transferee.

(iii) If a transferee who makes an election under section 617(a) receives mineral property in a transaction in

which the basis of such property in his hands is determined in whole or in part by reference to the basis of such property in the hands of the transferor and the transferor had in effect at the time of the transfer an election under section 615(e), an amount equal to the total of the amounts allowed as deductions to the transferor under section 615 with respect to the transferred property shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. The preceding sentence shall not apply to expenditures which could not have been reflected in the basis of the property in the hands of the transferee had the transferor not made the section 615(e) election.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On July 14, 1969, A purchased mineral property Z for \$10,000. After deducting exploration expenditures of \$20,000 under section 617(a), A transferred the property to his son as a gift on July 9, 1970. Since the exception for gifts in section 617(d)(3) (by incorporation by reference of the provisions of section 1245(b)(1)) applies, A does not recognize gain under section 617(d). On September 30, 1972 after deducting exploration expenditures of \$150,000 under section 617(a), the son transfers the mineral property to corporation X in a transaction under which no gain is recognized by the son under section 351. Since the exception of section 617(d)(3) (by incorporation by reference of the provisions of section 1245(b)(3)) applies, the son does not recognize gain under section 617(d). On November 14, 1972, corporation X sells the mineral property. No deductions for exploration expenditures were taken by corporation X. The amount of the adjusted exploration expenditures with respect to mineral property Z to be recaptured by corporation X upon such sale is \$170,000 (the total amount deducted by A and the son).

Example 2. Assume the same facts as in example 1 except that A deducted the \$20,000 of exploration expenditures under section 615(a). The amount of the adjusted exploration expenditures with respect to mineral property Z in corporation X's hands is \$170,000 (the \$20,000 deducted under section 615(a) by A plus the \$150,000 deducted under section 617(a) by the son).

(3) *Allocation of certain expenditures.* A project area consists of that territory which the taxpayer has determined by analysis of certain variables (the size

and topography of the area to be explored, existing information with respect to that area and nearby areas, and the quantity of equipment, men, and money available) can be explored advantageously as a single integrated operation. If exploration expenditures are paid or incurred with respect to a project area and one or more areas of interest are identified within such project area, the entire amount of such expenditures shall be allocated equally to each such area of interest. If an area of interest contains one or more mines or deposits the expenditures allocable to such area of interest shall be allocated (i) if only one mine or deposit is located or identified, entirely to such mine or deposit, or (ii) if more than one mine or deposit is located or identified, equally among the various mines or deposits located. For purposes of this subparagraph, the term *area of interest* means each separable, noncontiguous portion of the project area which is identified as possessing sufficient mineral-producing potential to merit further exploration. The provisions of this subparagraph may be illustrated by the following example: A pays \$100,000 for the exploration of a project area which results in the identification of two areas of interest. A pays an additional \$60,000 for the exploration of one of the areas of interest in which he locates mineral deposit X and mineral deposit Y. With respect to the exploration of deposit X he incurs an additional \$100,000 of expenses and with respect to deposit Y he incurs an additional \$200,000 of expenses. The exploration expenditures properly attributable to deposit X would be \$155,000 (\$100,000 plus one-half of \$50,000 plus one-half of \$60,000) and the exploration expenditures properly attributable to deposit Y would be \$255,000 (\$200,000 plus one-half of \$50,000 plus one-half of \$60,000).

(4) *Partnership distributions.* The adjusted exploration expenditures with respect to any property or mine received by a taxpayer in a distribution with respect to all or part of his interest in a partnership (i) include the adjusted exploration expenditures (not otherwise included under section 617(f)(1)) with respect to such property or mine immediately prior to such distribution and (ii) shall be reduced by

the amount of gain to which section 751(b) applies realized by the partnership (as constituted after the distribution) on the distribution of such property or mine. In the case of any property or mine held by a partnership after a distribution to a partner to which section 751(b) applies, the adjusted exploration expenditures with respect to such property or mine shall be reduced by the amount of gain (if any) to which section 751(b) applies realized by such partner with respect to such distribution on account of such property or mine.

(5) *Amount of transferee's adjusted exploration expenditures immediately after certain acquisitions—(i) Transactions in which basis is determined by reference to the cost or fair market value of the property transferred.* (a) If on the date a person acquires mining property his basis for the property is determined solely by reference to its cost (within the meaning of section 1012), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(b) If on the date a person acquires mining property his basis for the property is determined solely by reason of the application of section 301(d) (relating to basis of property received in corporate distribution) or section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(c) If on the date a person acquires mining property his basis for the property is determined solely under the provisions of section 334(b)(2) or (c) (relating to basis of property received in certain corporate liquidations), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(d) If on the date a person acquires mining property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then on

the date of acquisition the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(ii) *Gifts and certain tax-free transactions.* (a) If mining property is disposed of in a transaction described in (b) of this subdivision (ii), then the amount of the adjusted exploration expenditures for the mining property in the hands of a transferee immediately after the disposition shall be an amount equal to:

(1) The amount of the adjusted exploration expenditures with respect to the mining property in the hands of the transferor immediately before the disposition, minus

(2) The amount of any gain taken into account under section 617(d) by the transferor upon the disposition.

(b) The transactions referred to in (a) of this subdivision (ii) are:

(1) A disposition which is in part a sale or exchange and in part a gift, or

(2) A disposition which is described in section 617(d) through the incorporation by reference of the provisions of section 1245(b)(3) (relating to certain tax free transactions).

(iii) *Property acquired from a decedent.* If mining property is acquired in a transfer at death to which section 617(d) applies through incorporation by reference of the provisions of section 1245(b)(2), the amount of the adjusted exploration expenditures with respect to the mining property in the hands of the transferee immediately after the transfer shall include the amount, if any, of the exploration expenditures deducted by the transferee before the decedent's death, to the extent that the basis of the mining property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where the property is acquired from a decedent prior to his death).

(6) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. A owns the working interest in a large tract of land located in the United States. A's interest in the entire tract of land constitutes one property for purposes of section 614. In the northwest corner of this tract is an operating mine, X, producing an

ore of beryllium, which is entitled to a percentage depletion rate of 22 percent under section 613(b)(2)(B). During 1971, A conducts an exploration program in the southeast corner of this same tract of land, and he incurs \$400,000 of expenditures to which section 617(a)(1) applies in connection with this exploration program. A elects to deduct this amount as expenses under section 617(a). During 1971, A's *gross income from the property* computed under section 613 was \$1 million, with respect to the property encompassing mine X and the area in which exploration was conducted. A's *taxable income from the property* computed under section 613, before adjustment to reflect the deductions taken with respect to the property during the year under section 617, was \$400,000. The cost depletion deduction allowable and deducted with respect to the property during 1971 was \$50,000. The amount of adjusted exploration expenditures chargeable to the exploratory mine (hereinafter referred to as mine Y) at the close of 1971 is \$250,000, computed as follows:

Expenditures allowed as deductions under sec. 617(a)	\$400,000
Gross income from the property	\$1,000,000
22 percent thereof	220,000
Taxable income from the property, before adjustment to reflect deductions allowed under sec. 617 during year	400,000
50 percent thereof—tentative deduction	200,000
Taxable income from the property after adjustment to reflect deductions allowed under sec. 617 during year (\$400,000 minus \$400,000)	0
Cost depletion allowed for year	50,000
Amount by which allowance for depletion under sec. 611 was reduced on account of deductions under sec. 617 (\$200,000 minus \$50,000)	150,000
Adjusted exploration expenditures at end of 1971	250,000

Example 2. Assume the same facts as in example 1. Assume further that mine Y, with respect to which exploration expenditures were deducted in 1971, enters the producing stage in 1972, and that no deductions were taken under section 617 with respect to that mine after 1971. A does not make an election under section 617(b)(1)(A) during 1972. Assume that the depletion deduction which would be allowable for 1972 with respect to the property (which includes both mines) but for the application of section 617(b)(1)(B) is \$100,000. Pursuant to section 617(b)(1)(B), this depletion deduction is disallowed. Therefore,

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the amount of adjusted exploration expenditures with respect to mine Y at the end of 1972 is \$150,000 (\$250,000 less \$100,000).

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§ 1.617-4 Treatment of gain from disposition of certain mining property.

(a) *In general.* (1) In general, section 617(d)(1) provides, that, upon a disposition of mining property, the lower of (i) the *adjusted exploration expenditures* (as defined in section 617(f)(1) and paragraph (d) of § 1.617-3) with respect to the property, or (ii) the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition, exceeds the adjusted basis of the property, shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). However, any amount recognized under the preceding sentence shall not be included by the taxpayer in his *gross income from the property* for purposes of section 613. Generally, the ordinary income treatment applies even though in the absence of section 617(d) no gain would be recognized under any other provision of the Code. For example, if a corporation distributes mining property as a dividend, gain may be recognized as ordinary income to the corporation even though, in the absence of section 617, section 311(a) would preclude any recognition of gain to the corporation. For an exception to the recognition of gain with respect to dispositions which involve mineral production payments, see section 636 and the regulations thereunder. For the definition of the term *mining property*, see section 617(f)(2) and paragraph (c)(3), of § 1.617-3. For exceptions and limitations to the application of section 617(d)(1), see section 617(d)(3) and paragraph (c) of this section.

(2) In the case of a sale, exchange, or involuntary conversion of mining property, the gain to which section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the amount realized upon the disposition of the property over the adjusted basis of the property. In the case of a disposi-

tion of mining property other than by a manner described in the preceding sentence, the gain to which section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the fair market value of the property on the date of disposition over the adjusted basis of the property. In the case of a disposal of coal or domestic iron ore subject to a retained economic interest to which section 631(c) applies, the excess of the amount realized over the adjusted basis of the mining property shall be treated as equal to the gain, if any, referred to in section 631(c). For determination of the amount realized upon a disposition of mining property and nonmining property, see paragraph (c)(3)(i) of this section.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. On July 14, 1970, A purchased undeveloped mining property for \$100,000. During 1970, A incurred with respect to the property, \$50,000 of exploration expenditures which he deducts under section 617(a). In 1971, A incurred \$150,000 of exploration expenditures with respect to the property which he deducts on his income tax return. On January 2, 1972, A sells the mining property to B for \$250,000. A's gain on the sale is \$150,000 (\$250,000 amount realized minus \$100,000 basis). Since the excess of the amount realized over the adjusted basis of the mining property is less than the adjusted exploration expenditures with respect to the property (\$200,000), the entire gain is treated as ordinary income under section 617(d)(1).

Example 2. Assume the same facts as in example 1 except that A sells the mining property to B for \$400,000, thereby realizing gain of \$300,000 (\$400,000 minus \$100,000 basis). Since the amount of adjusted exploration expenditures with respect to the mining property (\$200,000) is less than the amount realized upon its disposition (\$300,000), an amount equal to the amount of adjusted exploration expenditures is treated as ordinary income under section 617(d)(1). The remaining \$100,000 is treated by A without regard to section 617(d)(1).

(4) Section 617(d) does not apply to losses. Thus, section 617(d) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of mining property, nor does section 617(d) apply to a disposition of mining property other than by way of sale, exchange, or involuntary conversion if at